REPORT OF THE AUDITOR OF PUBLIC ACCOUNTS
AUDIT EXAMINATION OF THE
KENTUCKY LOTTERY CORPORATION

Report on Audits of Financial Statements
for the years ended June 30, 1999 and 1998

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Edward B. Hatchett, Jr.
Auditor of Public Accounts

October, 1999

To the People of Kentucky
Honorable Paul E. Patton, Governor
Honorable Larry Saunders, President, Kentucky Senate
Honorable Jody Richards, Speaker, Kentucky House of Representatives
Board of Directors, Kentucky Lottery Corporation

As Auditor of Public Accounts, I am pleased to transmit herewith the eleventh full financial and compliance audit of the books and records of the Kentucky Lottery Corporation (Corporation) as required by KRS 154A.130.

The audit was performed by the independent accounting firm of PricewaterhouseCoopers LLP (firm) in accordance with generally accepted government auditing standards. The audit included the balance sheets as of June 30, 1999 and 1998; the related statements of revenues, expenses, and changes in retained earnings and cash flows for the years then ended; notes to the financial statements, and a report on compliance and internal controls, together with comments and recommendations on the Corporation's internal control.

The firm's report on the financial and compliance audit begins on page 5 of this report and is summarized as follows:

1) The Corporation's financial statements are presented fairly in all material respects.

2) At June 30, 1999, the Corporation's assets totaled $427,516,000, a decrease of $25,434,000 over June 30, 1998.

   Significant changes in assets from the prior year included:

   - Decrease in total investments (current and long-term) of $30,339,000.

   - Increase in accounts receivable (net) of $8,883,000.

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3) At June 30, 1999, the Corporation's liabilities and equity totaled $427,516,000, a decrease of $25,434,000 over June 30, 1998.

   Significant changes in liabilities and equity from the prior year included:

   - Decrease in retained earnings of $15,248,000 due to current year net loss.

   - Decrease in total estimated prize liability (current and long-term) of $15,162,000.

4) Significant items concerning the statements of revenue, expenses, and changes in retained earnings for the year ended June 30, 1999, included:

   - Gross profit was $202,453,000, an increase of $10,071,000 (5%) over 1998.

   - Operating expenses increased $5,453,000 (15%) over 1998.

   - Net income before transfer of dividends to the Commonwealth decreased $36,267,000 over 1998.

   - Dividends to the Commonwealth were $159,589,000, an increase of $6,589,000 over 1998. The increase included a transfer of $5,789,000 to the Affordable Housing Trust Fund from uncollected prize winnings.

   - Net (loss) income was ($15,248,000), a decrease of $42,856,000 compared to net income for 1998.

   - Retained earnings were $51,999,000, a decrease of $15,248,000 over 1998.

5) Significant items concerning the statement of cash flows for the year ended June 30, 1999, included:

   - Net cash provided by operating activities decreased $27,755,000 over 1998.

   - Net cash used in noncapital financing activities increased $6,589,000 over 1998.

   - Net cash used in capital and related financing activities decreased $32,000 over 1998.

   - Net cash provided by investing activities increased $25,867,000 over 1998.

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6) As discussed in Note 4, the Corporation has adopted GASB Statement No. 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools," which establishes accounting and reporting guidelines for government investments and investment pools. The adoption of this Statement requires investments to be presented at fair value. In prior years, investments were reported at cost and adjusted for the accretion of interest based upon the purchased yield and maturity date. The Corporation's net income increased from $9,099,000 in 1997 to $27,608,000 in 1998; however, it should be noted that $23,775,000 and $6,370,000 of the increase in 1998 and 1997, respectively was due to adoption of GASB Statement No. 31. In turn, the Corporation's net income decreased from $27,608,000 in 1998 to ($15,248,000) in 1999 from adoption of this same statement as a result of reporting investments at fair value instead of the historical cost method. The difference in the valuation of the investments for 1999 was ($17,482,000).

7) The Corporation defines gross revenues as total sales. For the year ended June 30, 1999, these totaled $583,145,000. Dividends paid to the Commonwealth totaled $153,800,000 or 26.4 percent of total sales.

   KRS 154A.130 states the intent of the Legislature regarding dividends paid to the Commonwealth:

   After the start-up costs are paid, it is the intent of the Legislature that it shall be the goal of the Corporation to transfer each year thirty-five percent (35%) of gross revenues to the general fund . . ..

   The Corporation did not meet this goal, since only 26.4 percent of total sales was transferred to the Commonwealth. The goal based on total sales of $583,145,000 would have been $204,100,750. This is a shortfall of $50,300,750 of the goal.

8) The Corporation's financial statements will be included in the Commonwealth of Kentucky's Comprehensive Annual Financial Report for the year ended June 30, 1999.

9) The firm tested the Corporation's compliance with certain provisions of laws, regulations, contracts, and grants. While not giving an opinion on the Corporation's overall compliance with such provisions, the firm did state that the results of their tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards.*

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10) The firm considered the Corporation's internal control over financial reporting in order to determine auditing procedures for the purpose of expressing an opinion on the financial statements, not to provide assurance on the internal control over financial reporting.

The firm noted no material weaknesses involving the internal control over financial reporting. However, the following other matters were reported to the Corporation’s management along with recommendations for improvement:

1. The Corporation’s management should continue to monitor their year 2000 plan to ensure timely completion of all work, including the development and testing of contingency plans.

2. The Corporation’s management should examine the possibility of obtaining the remaining funds that are held on deposit with the Finance and Administration Cabinet that remain from the purchase and renovation of the new Main Street headquarters project that was substantially completed during the fiscal year ended June 30, 1998.

The Corporation concurred with the comments and recommendations and indicated those actions that have already been taken or will be taken. Full descriptions of the matters, including the Corporation’s responses, are included in the firm’s report following this summary.

The Corporation has entered into an agreement with the public accounting firm of Crowe, Chizek and Company LLP to perform the function of “drawing auditor” for the computer on-line games operated by the Corporation during the year ended June 30, 1999. Quarterly reports on the results of the drawing observations and certifications are made by Crowe, Chizek and Company LLP for the on-line games. In addition, Crowe, Chizek and Company LLP observes and reports on the procedures used to certify the lotto balls used in all games. All reports are available for review in the Office of the Auditor of Public Accounts.

Respectfully submitted,

Ed Hatchett

Edward B. Hatchett, Jr.
Auditor of Public Accounts

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Report of Independent Accountants

To the Auditor of Public Accounts, Commonwealth of Kentucky and
the Board of Directors, Kentucky Lottery Corporation

In our opinion, the accompanying balance sheets and the related statements of revenue, expenses and changes in retained earnings, and cash flows present fairly, in all material respects, the financial position of the Kentucky Lottery Corporation (the Corporation), a component unit of the Commonwealth of Kentucky, at June 30, 1999 and 1998, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Corporation's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards and standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

In accordance with *Government Auditing Standards*, we have also issued our report dated August 26, 1999 on our consideration of the Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grants.

PricewaterhouseCoopers LLP

August 26, 1999

FINANCIAL STATEMENTS

FOR THE YEARS ENDED JUNE 30, 1999 AND 1998

Kentucky Lottery Corporation
Balance Sheets

June 30, 1999 and 1998
(dollars in thousands)

ASSETS	1999	1998
Current assets:		
Cash and equivalents	$ 22,711	$ 27,364
Investments at fair value, current portion	36,115	36,590
Accounts receivable, net	28,334	19,451
Ticket inventories	272	238
Deposits with Commonwealth of Kentucky	513	598
Other	308	321
Total current assets	88,253	84,562
Investments at fair value, less current portion	321,560	351,424
Property and equipment, net	13,968	12,976
Deposits with Multi-State Lottery Association	3,735	3,988
Total assets	$ 427,516	$ 452,950
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 9,685	$ 6,839
Dividends payable to the affordable housing trust fund	3,487	-
Notes payable, current portion	1,357	1,356
Estimated prize liability, current portion	53,926	55,111
Total current liabilities	68,455	63,306
Notes payable, less current portion	3,055	4,413
Estimated prize liability, less current portion	303,907	317,884
Total liabilities	375,417	385,603
Equity:		
Contributed capital	100	100
Retained earnings	51,999	67,247
Total equity	52,099	67,347
Total liabilities and equity	$ 427,516	$ 452,950

The accompanying notes are an integral part of the financial statements.

Kentucky Lottery Corporation
Statements of Revenue, Expenses and Changes in Retained Earnings

for the years ended June 30, 1999 and 1998
(dollars in thousands)

	1999	1998
Sales:		
Instant games	$ 277,763	$ 294,381
On-line games	305,382	290,608
Total sales	583,145	584,989
Direct costs:		
Commissions to retailers	34,378	35,037
Prize expense:		
Instant games	177,037	187,010
On-line games	163,635	163,070
Total prize expense	340,672	350,080
Ticket costs	5,642	7,490
Total direct costs	380,692	392,607
Gross profit	202,453	192,382
Operating expenses:		
Advertising and promotion	10,125	8,905
Salaries, wages and benefits	10,539	9,960
Contracted and professional services	13,538	9,892
Depreciation	2,839	2,114
Other general and administrative	5,317	6,034
Total operating expenses	42,358	36,905
Operating income	160,095	155,477
Nonoperating income (expenses):		
Investment (loss) income	(2,899)	48,402
Interest expense	(12,988)	(23,155)
Other income (expense)	133	(116)
Total nonoperating (expense) income	(15,754)	25,131
Net income before dividends paid	144,341	180,608
Dividends paid	159,589	153,000
Net (loss) income	(15,248)	27,608
Retained earnings, beginning of year	67,247	39,639
Retained earnings, end of year	$ 51,999	$ 67,247

The accompanying notes are an integral part of the financial statements.

Kentucky Lottery Corporation
Statements of Cash Flows
for the years ended June 30, 1999 and 1998
(dollars in thousands)

	1999	1998
Cash flows from operating activities:		
Cash received from customers	$ 574,398	$ 582,324
Cash payments to suppliers for goods and services	(431,298)	(412,048)
Cash payments to employees for services	(10,539)	(9,960)
Net cash provided by operating activities	132,561	160,316
Cash flows from noncapital financing activities:		
Dividends paid	(159,589)	(153,000)
Net cash used in noncapital financing activities	(159,589)	(153,000)
Cash flows from capital and related financing activities:		
Purchases of property and equipment, net	(4,038)	(3,911)
Proceeds from disposal of equipment	425	15
Repayments of long-term debt	(1,357)	(1,018)
Interest expense	(348)	(320)
Capitalized interest	-	(116)
Net cash used in capital and related financing activities	(5,318)	(5,350)
Cash flows from investing activities:		
Proceeds from sale of investments	38,605	40,229
Purchase of investments	(13,108)	(39,519)
Deposits with Multi-State Lottery Association	253	(676)
Investment income	1,943	1,792
Net cash provided by investing activities	27,693	1,826
Net (decrease) increase in cash and equivalents	(4,653)	3,792
Cash and equivalents at beginning of year	27,364	23,572
Cash and equivalents at end of year	$ 22,711	$ 27,364
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 160,095	$ 155,477
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	2,839	2,114
Increase (decrease) in cash due to changes in:		
Accounts receivable, net	(8,883)	(2,704)
Ticket inventories	(34)	1,652
Other assets	13	2,248
Accounts payable and accrued expenses	2,846	1,062
Dividends payable to the affordable housing trust fund	3,487	-
Estimated prize liability	(27,802)	467
Total adjustments	(27,534)	4,839
Net cash provided by operating activities	$ 132,561	$ 160,316

Noncash investing activities:

The accretion of interest on investments held to fund grand prizes, which increased prize liability, totaled $12,640 and $22,835 for the years ended June 30, 1999 and 1998, respectively. The net (decrease) increase in the fair value of investments during 1999 and 1998 was $(4,842) and $46,610, respectively.

The accompanying notes are an integral part of the financial statements.

Notes to Financial Statements

1. Organization:

The Kentucky Lottery Corporation (the Corporation) was created with the enactment of House Bill No. 1 in December 1988 as an independent de jure municipal corporation and political subdivision of the Commonwealth of Kentucky (the Commonwealth). The Corporation is to be managed in such a manner that enables the people of the Commonwealth to benefit from its profits and to enjoy the best possible lottery games. The operations of the Corporation are separate and distinct from other operations of the Commonwealth.

The Corporation commenced operations on April 4, 1989 with the sale of instant game tickets. Sales of on-line games began October 16, 1989. In January 1991, the Corporation joined the Multi-State Lottery Association, a group of states that combine lottery sales for on-line games.

2. Summary of Significant Accounting Policies:

a. **Reporting Entity:** The Corporation has adopted the provisions of Government Accounting Standards Board (GASB) Statement No. 14, "The Financial Reporting Entity," under which the financial statements include all the organizations, activities, functions and component units for which the Corporation is financially accountable. Financial accountability is defined as the appointment of a voting majority of the component unit's board, and either (1) the Corporation's ability to impose its will over the component unit, or (2) the possibility that the component unit will provide a financial benefit to or impose a financial burden on the Corporation.

   The Corporation has determined that no outside agency meets the above criteria and, therefore, no other agency has been included as a component unit in the Corporation's financial statements. In addition, since the Corporation provides a financial benefit for the Commonwealth, the Corporation is part of the reporting entity of the Commonwealth and is, therefore, included in the Commonwealth's Annual Financial Report.

b. **Basis of Presentation:** The Corporation is accounted for as an enterprise fund. The financial statements are prepared on the accrual basis of accounting in accordance with generally accepted accounting principles. The Corporation has elected to apply all applicable GASB pronouncements as well as Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board (APB) opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. The Corporation has further elected not to apply FASB pronouncements issued after November 30, 1989.

c. **Revenue and Accounts Receivable Recognition:** Revenue and accounts receivable for on-line games are recognized when tickets are sold to the public by contracted retailers.

   Revenue and accounts receivable for instant scratch games are recognized upon activation of tickets for sale by the retailers, or 50 days from the date of issuance of the tickets to the retailers, whichever is sooner.

Notes to Financial Statements, Continued

2. Summary of Significant Accounting Policies, continued:

d. Prizes: Prize expense for instant ticket games is recorded as an estimate at the time the related revenue is recognized based on the predetermined prize structure for each game; periodically, the prize expense is adjusted to reflect amounts actually won. Prize expense for on-line games is recorded at the time the related revenue is recognized based on the known prize payout structure.

Grand prizes are awarded related to the Lotto Kentucky and Powerball on-line games. Lotto Kentucky grand prizes are paid in twenty equal annual installments or in a single lump-sum payment equal to the estimated present cash value of twenty annual payments. For Lotto Kentucky winners electing annual installments, the actual prize expense is the cost of the U.S. Treasury zero coupon bonds which the Corporation purchases to fund the annual payments. For Lotto Kentucky winners electing present cash value, the actual prize expense is the lump-sum payment equal to the cost of U.S. Treasury zero coupon bonds, priced seven days prior to the draw date, as if the Corporation was to fund twenty equal annual installments.

Powerball grand prizes are paid in twenty-five equal annual installments or in a single lump-sum payment equal to the estimated present cash value of twenty-five annual payments. The Corporation recognizes Powerball prize expense at the time the related revenue is recognized based on the known prize payout structure. A portion of Powerball sales of the Corporation is remitted to the Multi-State Lottery Association (MUSL) to fund prize payments. MUSL purchases U.S. Government agency securities to fund prize liability to Powerball winners electing annual installments.

e. Cash and Equivalents: For financial statement purposes, the Corporation considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

f. Investments: Investments consist of U.S. Treasury zero coupon bonds and other U.S. Government agency securities carried at fair value in accordance with GASB Statement No. 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools." Fair value of investments is based on quoted market prices.

g. Ticket Inventories: Inventories are carried at cost (as determined by the specific identification method) and consist of pull-tab tickets located in the Corporation's warehouses or held by retailers. The cost of tickets is charged to operations upon the recognition of revenue under the procedures described above.

Notes to Financial Statements, Continued

2. Summary of Significant Accounting Policies, continued:

h. Property and Equipment: Property and equipment are carried at cost less accumulated depreciation. Depreciation is computed using the straight-line method over estimated lives of three to thirty years. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations in the period of disposal. Amortization of leasehold improvements is computed using the straight-line method over lease terms of three to five years.

i. Deposits with Multi-State Lottery Association (MUSL): Deposits are carried at cost. MUSL is an unincorporated government-benefit voluntary association created for the purpose of administering joint lottery games. MUSL currently includes 21 state lottery entities and the District of Columbia and sells two games known as Powerball and Daily Millions. The chief executive officer of each member lottery serves on the MUSL board of directors. As a member of MUSL, the Corporation is required to contribute to various prize reserve funds maintained by MUSL. The prize reserve funds serve as a contingency reserve to protect MUSL from unforeseen prize liabilities. All funds remitted, and the related interest earnings, will be returned to the Corporation upon leaving MUSL, less any portion of unanticipated prize claims which may have been paid from the fund.

j. Estimated Prize Liability: A liability for grand prize winners electing equal annual installments is recorded based on the cost of U.S. Treasury zero coupon bonds and other U.S. Government agency securities purchased to fund the liability, adjusted for the accretion of interest based upon the purchased yield and maturity date. The estimated prize liability is presented in the balance sheet net of this imputed interest. Imputed interest is amortized to interest expense over the life of the annuity utilizing the effective interest method.

k. Dividends Payable to the Affordable Housing Trust Fund: A liability for dividends payable results from unclaimed prizes on instant and on-line games. In accordance with Kentucky Revised Statute (KRS) 154A.110(3), any unclaimed prize money from these games may be retained by the Corporation and added to the pool from which future prizes are to be awarded or used for special prize promotions, or may be appropriated by the General Assembly directly from the Corporation for any public purpose. Any unclaimed prize money in excess of $6,000,000 per fiscal year is transferred to the affordable housing trust fund, as required by KRS section 154A.110(3). Payments are made as necessary during January and July of each fiscal year, depending on the volume of unclaimed prizes.

l. Dividends Paid: Dividends paid represents a transfer of funds from the Corporation to the Commonwealth's general fund and the affordable housing trust fund. The dividends paid to the general fund, which are approved by the Board of Directors and remitted to the Commonwealth on a monthly basis, are used to benefit all Kentuckians. The dividends paid to the affordable housing trust fund are used to address the critical housing needs of extremely low income Kentuckians.

Notes to Financial Statements, Continued

2. Summary of Significant Accounting Policies, continued:

m. Use of Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

n. Reclassifications: Certain prior year amounts have been reclassified to conform with the current year presentation.

3. Cash and Equivalents:

Cash and equivalents includes amounts held in bank accounts with book overdrafts of approximately $736,000 and bank balances of approximately $242,000 at June 30, 1999. Such balances are fully covered by federal depository insurance. Also included in cash and equivalents at June 30, 1999 are overnight repurchase agreements of $23,447,000 which are classified as Category 1 investments. The Corporation's investments are categorized to give an indication of the level of credit risk assumed by the Corporation at year-end. Category 1 is comprised of investments that are either insured or registered, or for which the securities are held by the Corporation's agent in the Corporation's name.

4. Investments:

The Corporation has adopted GASB Statement No. 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools," which establishes accounting and reporting guidelines for government investments and investment pools. The adoption of this statement requires investments to be presented at fair value, resulting in additional (loss) income, when compared to the historical cost method, of approximately $(17,482,000) and $23,775,000 in 1999 and 1998, respectively.

Notes to Financial Statements, Continued

4. Investments, continued:

Retained earnings at June 30 consisted of (in thousands):

	1999	1998
Retained earnings excluding unrealized gains on investments	$ 31,988	$ 29,754
Unrealized gains on investments	20,011	37,493
	$ 51,999	$ 67,247

The net increase in the fair value of investments includes all changes in fair value (including purchases and sales) that occurred during the year. The components of investment (loss) income for the years ended June 30, 1999 and 1998 follow:

	1999	1998
Investment (loss) income:		
Net (decrease) increase in fair value of investments	$ (4,842)	$ 46,610
Interest income	1,795	1753
Security lending income	148	39
Total investment (loss) income	$ (2,899)	$ 48,402

All investments held at June 30, 1999 and 1998 were in Category 1 and were held in U.S. Treasury zero coupon bonds and other U.S. Government agency securities.

The Corporation is authorized by state statutes and investment policies approved by the board of directors to lend its investment securities. The lending is managed by the Corporation's custodial bank. All loans can be terminated on demand by either the Corporation or the borrowers, although the average term of loans is approximately one week. The custodial bank and its affiliates are prohibited from borrowing the Corporation's securities.

The agent lends the Corporation's U.S. Treasury zero coupon bonds and other U.S. Government agency securities for securities collateral of 102 percent. The securities lending contracts do not allow the Corporation to pledge or sell any collateral securities unless the borrower defaults. There are no restrictions on the amount of securities that can be lent at one time or to one borrower.

At June 30, 1999 and 1998, the Corporation had loaned investments with fair values of approximately $76,199,000 and $104,760,000, respectively, to authorized brokers for a fee. In exchange for the loaned investments, the Corporation has temporarily received direct obligations of the U.S. Treasury and securities issued by U.S. Government agencies with fair values of approximately $78,468,000 and $104,997,000 at June 30, 1999 and 1998, respectively, which are held by the Corporation's custodial bank in the Corporation's name. The Corporation's loaned investments are included in the investments reported in the financial statements rather than the securities received in the exchange.

Notes to Financial Statements, Continued

4. Investments, continued:

The lending agent provides indemnification if the borrowers fail to return the underlying securities (and if the collateral is inadequate to replace the securities lent) or fail to pay income distributions on them. There were no violations of legal or contractual provisions, no borrower or lending agent default losses, and no recoveries of prior-period losses during the year. There are no income distributions owing on the securities lent. All borrower rebates, agent fees, and lender's net earnings were fully paid at year-end.

5. Accounts Receivable:

Accounts receivable at June 30 consisted of (in thousands):

	1999	1998
Accounts receivable	$ 28,917	$ 20,046
Allowance for doubtful accounts	(583)	(595)
Accounts receivable, net	$ 28,334	$ 19,451

6. Property and Equipment:

Property and equipment at June 30 consisted of (in thousands):

	1999	1998
Buildings	$ 7,103	$ 7,013
Land	423	423
Leasehold improvements	326	308
Game equipment	9,492	8,483
Data processing equipment	12,473	10,204
Automobiles, furniture and fixtures	2,956	3,072
Construction in progress	20	17
	32,793	29,520
Accumulated depreciation	(18,825)	(16,544)
Property and equipment, net	$ 13,968	$ 12,976

During 1998, interest of approximately $116,000 was capitalized in conjunction with borrowings related to the renovation of real estate to be used as new corporate headquarters. There was no interest capitalized during 1999.

Notes to Financial Statements, Continued

7. Notes Payable:

On December 18, 1996, the Corporation borrowed $6,787,000 to fund the renovation of real estate purchased during the year ended June 30, 1996 to be used as new corporate headquarters. The terms of the loan require monthly interest payments beginning December 31, 1996 with an annual interest rate of 6.66%. Principal payments began in October 1997 and are due in 60 monthly installments.

Scheduled maturities of the Corporation's notes payable are as follows (in thousands):

2000	$ 1,357
2001	1,357
2002	1,357
2003	341
	$ 4,412

8. Estimated Prize Liability:

Estimated prize liability at June 30 consisted of (in thousands):

	1999	1998
Current:		
Grand prizes	$ 36,115	$ 36,589
Other prizes	17,811	18,522
	$ 53,926	$ 55,111
Long-term:		
Grand prizes	$ 506,669	$ 528,081
Less imputed interest	(202,762)	(210,197)
	$ 303,907	$ 317,884

Estimated prize liability for grand prizes is based on the cost of U.S. Treasury zero coupon bonds and other U.S. Government agency securities purchased to fund the liability, adjusted for the accretion of interest based upon the purchased yield and maturity date. This adjustment of approximately $12,640,000 and $22,835,000 in 1999 and 1998, respectively, is included in interest expense. Interest expense for the years ended June 30, 1999 and 1998 consisted of (in thousands):

	1999	1998
Amortization of discount on estimated prize liability	$ 12,640	$ 22,835
Interest on notes payable	348	320
Total interest expense	$ 12,988	$ 23,155

Notes to Financial Statements, Continued

9. Retirement Plan:

The Corporation has a defined contribution retirement plan (the Plan) which covers all full-time employees. Under the terms of the Plan, the Corporation and employees each contribute 6.2% of the employee's earned annual base salary, as defined. Employees become eligible for participation and are fully vested at the date of employment for this portion of the Plan.

The Corporation also makes a contribution equal to 8% of the employee's earned annual base salary. For this portion, employees hired prior to October 1, 1993 became eligible at the date of employment and are fully vested providing participation requirements are met. Employees hired after September 30, 1993 become eligible one year after the date of employment and are fully vested after five years of service providing participation requirements are met.

For 1999 and 1998, total payroll was approximately $8,321,000 and $8,183,000, respectively. During 1999 and 1998, the Corporation's contributions were calculated using the base salary amount for full-time employees of $7,906,071 and $7,397,000, respectively, for the 6.2% employer match contribution, and $7,553,000 and $7,055,000, respectively, for the 8% additional employer contribution. Employer requirements and contributions actually made to the Plan were approximately $1,073,000 and $1,016,000 (14.2% and 14.4% of covered payroll) and employee contributions to the Plan were approximately $466,000 and $438,000 (6.20% and 6.21% of covered payroll) in 1999 and 1998, respectively.

10. Leases:

The Corporation has entered into operating leases for the rental of office and warehouse space under initial lease terms of one to five years.

Approximate minimum rental payments are (in thousands):

Year Ending June 30,		
2000	$	247
2001		203
2002		85
2003		-
	$	535

Rental expense for 1999 and 1998 was approximately $285,000 and $444,000, respectively.

Notes to Financial Statements, Continued

11. Dividends Paid:

Dividends paid for the years ended June 30, 1999 and 1998 are summarized as follows (in thousands):

	1999	1998
General fund	$ 153,800	$ 153,000
Affordable housing trust fund	5,789	-
	$ 159,589	$ 153,000

Dividends paid to the general fund for the year ended June 30, 1999 included $14,000,000 that was required by KRS 154A.130(4)(b) to be credited from the general fund to the College Access Program and the Kentucky Tuition Grants Program.

12. Insurance:

The Corporation is exposed to various risks of loss related to torts; theft of, damage to, and the destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Corporation has purchased commercial insurance to cover these risks except for the asset value of certain gaming equipment located at retail establishments in which the Corporation retains risk of loss. As of June 30, 1999, there were no outstanding liabilities or unpaid claims regarding this gaming equipment. The amount of commercial coverage has not decreased nor has the amount of settlements exceeded coverage in any of the past three fiscal years. It is also the policy of the Corporation to purchase a portion of the medical insurance needed to cover its employees.

13. Internal Revenue Code Section 451(h):

As part of the Omnibus Consolidated and Emergency Supplemental Appropriations Bill for Fiscal Year 1999, Congress changed the rules under which certain lottery prizes are taxed. The changes to Section 451(h) of the Internal Revenue Code became effective on October 21, 1998. A transition rule provision exists that allows pre-October 22, 1998 winners, if there is an option, to elect a single cash payment of the remaining value of their prize within an 18-month period beginning July 1, 1999.

As of the date of this report, the Corporation has not made the single cash payment prize option available to its annuity holders. The Corporation cannot determine, at this date, the ultimate financial statement impact of any potential change in the Corporation's policies to permit the single cash payment election.

Notes to Financial Statements, Continued

14. Impact of New Accounting Standards:

In June of 1999, the Governmental Accounting Standards Board issued GASB Statement No. 34, "Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments." This statement is effective for financial statements for fiscal years beginning after June 15, 2001. Management has not yet assessed the impact that the adoption of GASB No. 34 will have on the Corporation's financial statements.

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Report of Independent Accountants on Required Supplementary Information

To the Auditor of Public Accounts, Commonwealth of Kentucky and
the Board of Directors, Kentucky Lottery Corporation

Our report on the audit of the financial statements of the Kentucky Lottery Corporation (the Corporation) as of June 30, 1999 and for the year then ended is presented in the first section of this document. Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The year 2000 supplementary information on page 16 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board, and we did not audit and do not express an opinion on such information. Further, we were unable to apply to the information certain procedures prescribed by professional standards because the disclosure criteria specified by TB 98-1, as amended, are not sufficiently specific and, therefore, preclude the prescribed procedures from providing meaningful results. In addition, we do not provide assurance that the Corporation is or will become year 2000 compliant, that the Corporation's year 2000 remediation efforts will be successful in whole or in part, or that parties with which the Corporation does business are or will become year 2000 compliant.

PricewaterhouseCoopers LLP

August 26, 1999

Year 2000 Supplementary Information (Unaudited):

The year 2000 issue is the result of shortcomings in many electronic data processing and other electronic equipment that may affect the Corporation's operations as early as fiscal year 1999.

The Corporation has identified 14 mission critical systems that may be affected by the year 2000 issue and that are necessary to conducting Corporation operations. All of these systems, except for our telecommunication network and certain ancillary systems, have been remediated, tested, and implemented. The remaining systems will be tested and, if necessary, remediated by November 1999.

Remaining contracted amounts of approximately $465,000 are committed to this project as of June 30, 1999.

Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter.

REPORT ON COMPLIANCE AND ON INTERNAL CONTROL

FOR THE YEAR ENDED JUNE 30, 1999

PRICEWATERHOUSECOOPERS

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Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards

To the Auditor of Public Accounts, Commonwealth of Kentucky and
the Board of Directors, Kentucky Lottery Corporation

We have audited the financial statements of the Kentucky Lottery Corporation (the Corporation) as of and for the year ended June 30, 1999, and have issued our report thereon dated August 26, 1999. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

Compliance:

As part of obtaining reasonable assurance about whether the Corporation's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards.*

Internal Control Over Financial Reporting:

In planning and performing our audit, we considered the Corporation's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted other matters involving the internal control over financial reporting that we have reported to management of the Corporation in a separate letter dated August 26, 1999.

This report is intended solely for the information and use of the audit committee, management of the Corporation and the Auditor of Public Accounts of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than these specified parties.

PricewaterhouseCoopers LLP

August 26, 1999

COMMENTS AND RECOMMENDATIONS

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
Suite 1800
500 West Main Street
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August 26, 1999

Mr. Arthur L. Gleason
Kentucky Lottery Corporation

In planning and performing our audit of the financial statements of the Kentucky Lottery Corporation (the Corporation), a component unit of the Commonwealth of Kentucky, for the year ended June 30, 1999, we considered the Corporation's internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. Although our audit was not designed to provide assurance on the internal control, we noted certain matters involving the internal control and its operation, and are submitting for your consideration related recommendations designed to help the Corporation make improvements and achieve operational efficiencies. Our comments reflect our desire to be of continuing assistance to the Corporation.

This report is intended solely for the information and use of the audit committee, management and the Auditor of Public Accounts and should not be used for any other purpose. However, this report is a matter of public record and its distribution is not limited.

We appreciate the cooperation we have received from Corporation personnel in connection with developing these recommendations. Should you have any questions about our recommendations, this letter, or other matters, please contact us at your convenience.

Very truly yours,

PricewaterhouseCoopers LLP

DDC:dsk
DRG

Current Year Comments

1. Year 2000 Issue:

Comment:

As the year 2000 approaches, a critical issue has emerged regarding how existing application software programs can accommodate this date value. In brief, many existing application software products in the marketplace as well as internally developed legacy systems were designed to only accommodate a two digit date position which represents the year. As such, the year 1999 may be the maximum value these system can process accurately.

The Corporation has developed a plan to address year 2000 issues and has only limited testing and contingency plan development remaining at this time.

Potential Effect:

Many Information Technology (IT) experts believe data integrity problems and erroneous calculations will occur and cause application systems to fail. The efforts and associated costs to address the year 2000 issue could be significant.

Recommendation:

We recommend that management continue to monitor their year 2000 plan to ensure timely completion of all work, including the development and testing of contingency plans. Management should continue to address this issue at a business wide level to ensure a smooth transition into the new millennium.

Management's Response:

The Corporation has been working diligently to identify and test year 2000 issues and agrees with the stated comment and recommendation. To minimize business disruption due to year 2000 issues, the Corporation, along with Keane, Inc., has developed a comprehensive plan to assess, remediate, and test all mission critical systems with potential year 2000 issues. Our plan includes vendor compliance, remediation and testing of all KLC internally developed or administered systems, testing of the GTECH gaming system, testing of embedded systems, such as HVAC and backup power supplies, contingency planning, and an end-to-end test of our gaming system network. We have also performed on-site year 2000 tests with our instant ticket vendor, Scientific Games, to ensure that we continue to receive ticket stock after January 1, 2000.

The execution of our plan is nearly complete, with only the end-to-end network test and some embedded system tests remaining. We will complete our testing on these systems by October 31, 1999, and move into Phase III of our project at that time. Phase III involves testing changes to already certified code and testing any new systems or applications that may be purchased or developed in-house.

2. Funds on Deposit with the Commonwealth of Kentucky:

Comment:

During fiscal year 1997, the Kentucky Lottery Corporation made an initial deposit of approximately $7 million to the Commonwealth of Kentucky for the purchase and renovation of the new Main Street headquarters. The balance of the deposit was $513,000 as of June 30, 1999. The project was substantially completed during the fiscal year ended June 30, 1998 and only dominimus amounts from the deposit was used during the fiscal year ended June 30, 1999.

Effect:

Funds on deposit with the Commonwealth of approximately $513,000 were not available for dividend to the Commonwealth as of June 30, 1999.

Recommendation:

We recommend these funds be remitted back to the Corporation, increasing funds available for dividend to the Commonwealth.

Management's Response:

Management agrees with the recommendation and will continue to pursue the release of these funds from the State Treasury back to the Corporation.

Prior Year Comments

3. Year 2000 Issue:

Comment:

As the year 2000 approaches, a critical issue has emerged regarding how existing application software programs can accommodate this date value. In brief, many existing application software products in the marketplace as well as internally developed legacy systems were designed to only accommodate a two digit date position which represents the year. As such, the year 1999 may be the maximum value these systems can process accurately.

The Corporation has developed a plan to address year 2000 issues, upgraded its accounting software, JD Edwards, to the most recent version available, and implemented a new on-line gaming system and instant ticket validation system. It should be noted that the Corporation is currently in the remediation phase of their plan to address year 2000 issues, having committed significant internal human resources and $2.3 million over the life of the project. This project is one of the largest Information Technologies projects undertaken by the Corporation since start-up in 1989. Completion of the project is scheduled for March 31, 1999.

Potential Effect:

When the year in the system is represented by "00," many IT experts believe data integrity problems and erroneous calculations will occur and cause application systems to fail. The efforts and associated costs to address the year 2000 issue could be significant.

Recommendation:

We recommend that management continue to monitor their year 2000 plan to ensure timely completion of all phases. Management should continue to address this issue at the business wide level to ensure a smooth transition into the new millennium.

Management's Response:

Over the life of this project, the Corporation has committed more than $2.3 million to ensuring that its software will process properly in the year 2000 and beyond. We will continue the process now in progress to fully remediate, test, and implement all software used by the Corporation, and will continue to incorporate year 2000 testing through and beyond the start of the new millennium. Remediation is scheduled to be complete March 31, 1999.

3. Year 2000 Issue, continued:

Management's Updated Response:

The Corporation has been working diligently to identify and test year 2000 issues and agrees with the stated comment and recommendation. To minimize business disruption due to year 2000 issues, the Corporation, along with Keane, Inc., has developed a comprehensive plan to assess, remediate, and test all mission critical systems with potential year 2000 issues. Our plan includes vendor compliance, remediation and testing of all KLC internally developed or administered systems, testing of the GTECH gaming system, testing of embedded systems, such as HVAC and backup power supplies, contingency planning, and an end-to-end test of our gaming system network. We have also performed on-site year 2000 tests with our instant ticket vendor, Scientific Games, to ensure that we continue to receive ticket stock after January 1, 2000.

The execution of our plan is nearly complete, with only the end-to-end network test and some embedded system tests remaining. We will complete our testing on these systems by October 31, 1999, and move into Phase III of our project at that time. Phase III involves testing changes to already certified code and testing any new systems or applications that may be purchased or developed in-house.

4. Preparation of On-Line Accounts Receivable Reconciliations:

Comment:

During the performance of our audit procedures on the accounts receivable and on-line revenue functions, we noted that reconciliations of on-line revenue were not prepared on a timely basis. The lack of an integrated on-line accounts receivable system necessitates a manual reconciliation process at the end of each month to ensure on-line accounts receivable are properly recorded. Prior to completion of our field work, the Corporation's accounting personnel reconciled the account as of June 30, 1998.

Potential Effect:

Preparation of monthly reconciliations and the review of reconciliations is vital to the maintenance of adequate internal accounting controls and to ensure that account balances are accurate and in agreement with the general ledger. Reconciliations performed infrequently or not reviewed could result in outages not being resolved on a timely basis.

Recommendation:

With the implementation of the new computer system that went live on June 28, 1998, management should examine the possibility of automating this process to allow for easier preparation. If the process cannot be automated, manual reconciliations and supervisory review of these reconciliations should be performed on a timely basis.

Management's Response:

The Corporation's management has addressed this issue and will begin development of an automated on-line accounts receivable system, with an automated reconciliation process, following the completion of the year 2000 project. It is not advisable to begin this project before completion of year 2000 work, due to change control management implications.

Management's Updated Response:

This project is scheduled to begin in March 2000.